

U.S. Balance-of-Payments Problems and Policies in 1971

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THE MAGNITUDE of the United States balance-of-payments deficit and concern about the effective operation of the international monetary system dominated thinking about U.S. payments problems and policies in 1971. Dollar outflows had long been critical to the functioning of the Bretton Woods system, but the continuous accumulation of dollars by foreigners, the relative fixity of exchange rates, and effectively integrated money and capital markets led many to seek reform of the international monetary system during 1971. The objective of most proposed reforms was to diminish the importance of the dollar in the system's operation and to promote a more effective means of adjusting countries' external payments positions, including that of the United States.

For years, dollar deficits had been beneficial to both U.S. and foreign residents. Foreigners used the dollars to finance trade imbalances and to minimize costs of holding liquid transactions balances in several currencies. Countries chose to use dollars to meet their exchange rate stability obligations as members of the International Monetary Fund (IMF). New York money and capital markets served as the primary source of funds (dollars) for American and foreign enterprises and dollars played a critical role in the formation and development of an important interbank market for funds — the Eurodollar market.

As U.S. payments deficits persisted, the supply of dollars in the hands of foreign residents became more than was necessary for minimal foreign private liquidity purposes and for exchange into American goods and financial instruments. The willingness of private foreigners to hold additional dollar deposits (or dollar claims) above minimum levels declined after the mid-1960s when the potential dollar claims exceeded the available gold stock. Evidence of the decline in demand for dollars was indicated by their sale to central banks by private foreigners. It was the continuing dollar deficits plus the decline in the willingness of

foreigners to hold dollar balances that finally hindered effective operation of the international monetary system in 1971.

In May, official foreigners indicated their unwillingness to accumulate more dollars. On August 15 the United States indicated it was no longer willing to tolerate the projected balance-of-payments deficits. It suspended convertibility of dollars into gold, imposed an import surcharge, and announced its intention to seek a realignment of parity rates and multinational cooperation on reform of the international monetary system.

Reactions to the Deficit

Reactions to the U.S. payments deficit in 1971 were divided into two time periods by the President's announcement of August 15.

Prior to August 15

Recent marked reserve accumulation among industrial countries other than the United States began in 1970. Little importance was attached to the fact at that time. Many nations had seen some decline in the foreign exchange component of their reserves from preceding years with the flow of short-term dollars from Europe to the United States. The reserve inflows in 1970 returned the reserve balances to their previous levels, but as the U.S. deficit increased in 1971, reserve accumulation became a source of concern.

In early April, all major currencies began to appreciate against the dollar in the forward exchange markets because of the large interest-rate differentials between this country and abroad, and perhaps, in anticipation of an impending formal decline in the relative value of the dollar. Many industrial countries had difficulty in restraining domestic inflation while meeting their exchange-rate stability responsibilities

Table 1

Official Reserves of Selected Industrial Countries, 1968-71*

(Billions of Dollars; End of Period)

Country	1968	1969	1970	1971			
				March	June	September	December**
United States	\$15.7	\$17.0	\$14.5	\$14.3	\$13.5	\$12.1	\$13.2
United Kingdom	2.4	2.5	2.8	3.3	3.6	5.0	6.6
Belgium	2.2	2.4	2.8	3.1	3.2	3.4	3.5
France	4.2	3.8	5.0	5.5	5.7	7.3	8.2
Italy	5.3	5.0	5.4	6.0	6.1	6.7	6.8
Netherlands	2.5	2.5	3.2	3.5	3.5	3.6	3.8
West Germany	9.9	7.1	13.6	15.8	16.7	17.0	18.4
Canada	3.0	3.1	4.7	4.8	4.9	5.0	5.7
Japan	2.9	3.7	4.8	5.9	7.8	13.4	15.4
Sweden	.8	.7	.8	.9	1.0	1.0	1.1
Switzerland	4.3	4.4	5.1	4.6	5.1	6.5	7.0

*Includes \$3.4 billion SDR allocated on January 1, 1970, and \$2.9 billion allocated on January 1, 1971. The U.S. share in these allocations was \$867 million and \$717 million, respectively.

**Reserve figures are restated to reflect the anticipated rise in the dollar price of gold from \$35 to \$38 an ounce and the realignment of currencies in late December.

Source: International Monetary Fund

under the rules of the IMF.¹ Swap lines with Belgium, the Netherlands, Switzerland and Germany were activated in an attempt to reduce declines in U.S. reserve assets. Further action by the United States to slow the dollar outflow involved the renewed sale by the Export-Import Bank and the U.S. Treasury of special three-month certificates of indebtedness to foreign branches and agencies of U.S. banks. Several foreign central banks lowered their discount rates in late March and April in order to narrow, or even reverse, the interest arbitrage spreads which had been in favor of domestic currencies in the first quarter.

The Eurodollar market remained calm in the first quarter of 1971 as it had throughout 1970. Eurodollar rates declined as many Eurodollar borrowings were repaid, particularly by U.S. banks, and rates fell well below most European interest rates. In contrast to normal times of 1970 and early 1971, when the Eurodollar market served as an international intermediary both for depositors seeking high rates of return on their money balances and for borrowers seeking lower cost credit than they could obtain at home, the Eurodollar market took on an increasingly speculative tone in the second quarter of 1971. As exchange rate uncertainties increased and banks and businesses borrowed funds in the Eurodollar market for conversion into domestic currencies, the rate rose rapidly. In

April and early May the three-month rate climbed to about 7.5 percent and overnight rates on individual days reached 45 percent or more. In late May and June the rate receded, but in late July and August the three-month rate rose again to nearly a 9 percent level with the overnight rate soaring to 200 percent on the last day of August.

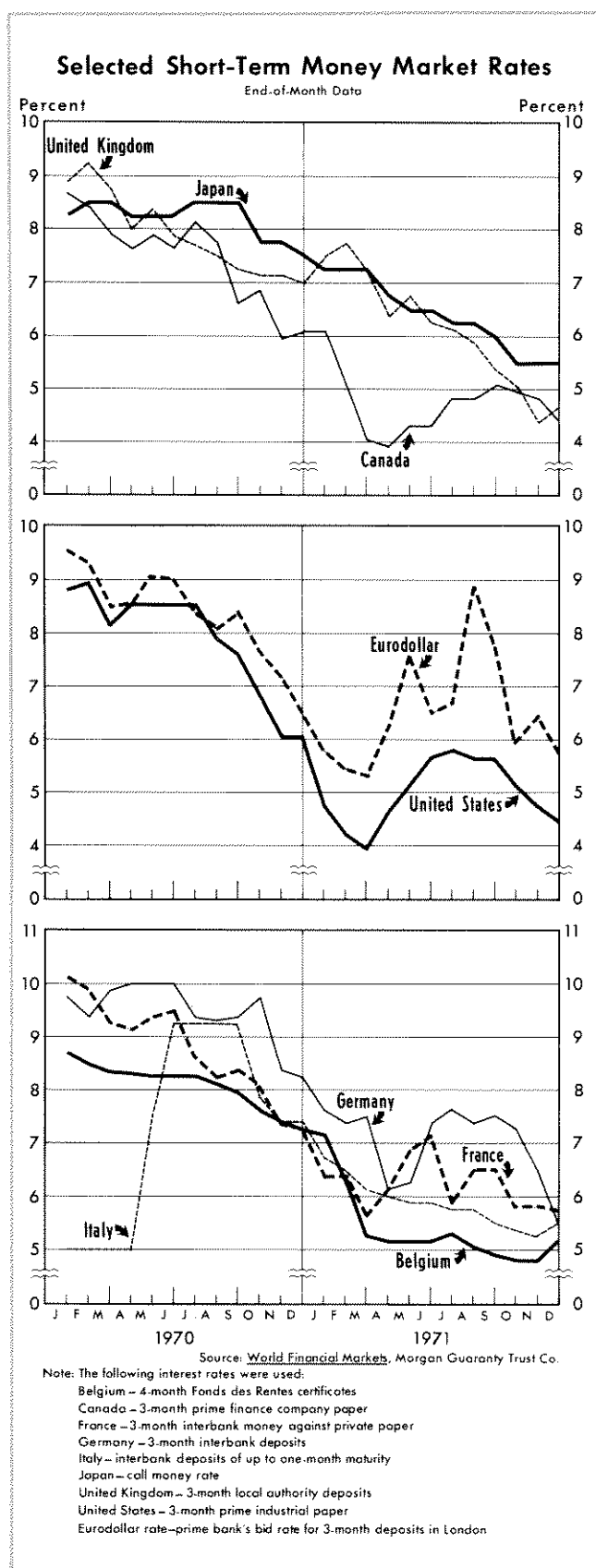
The country most sensitive to the U.S. deficit and international financial conditions in the first half of the year was Germany. Faced with a particularly large inflow of dollars, substantial domestic inflation, and interest rates well above the Eurodollar

and most European money market rates, the Bundesbank suspended its foreign exchange operations in the wake of a \$1 billion inflow over May 3-4, and an additional \$1 billion inflow in the first forty minutes of trading on the morning of May 5. The Frankfurt market reopened on May 10 with an announcement by the Bundesbank that trading limits for the mark would be suspended temporarily, although the official parity was to remain unchanged. This action permitted the German government to continue its restrictive stabilization policies. It chose to supplement the action by announcing on June 2 an increase in banks' minimum reserve requirements of 15 percent across the board, while the requirements against foreign liabilities were raised to twice the level of the new domestic requirements.

Shortly after the German decision, speculative pressures shifted to other "strong" national currencies. The Netherlands subsequently permitted the guilder to fluctuate and Belgium strengthened its two exchange rate system — one official and one financial — and permitted the latter to appreciate. Switzerland and Austria raised their parities by 7.07 and 5.05 percent, respectively.

The release of the second quarter U.S. balance-of-payments data indicated a marked deterioration in the U.S. external position, and when combined with the behavior of fluctuating exchange rates in July and August, offered additional evidence that the dollar might need to be devalued. U.S. reserve assets had diminished to about \$12.1 billion in mid-August from \$14.6 billion at the beginning of the year, and nearly 45 percent of the \$2.5 billion decline came in early

¹Under rules of the IMF, countries were responsible for limiting exchange-rate fluctuation to one percent on either side of parity throughout most of 1971. After December 18 the range of permissible exchange-rate fluctuation was increased to 2¼ percent on either side of parity for most countries.



August. Although the United States again drew heavily on its swap lines of credit, private and public pressures to convert dollars into other currencies and ultimately U.S. reserve assets became overwhelming.² The United States suspended convertibility of the dollar into gold on August 15.

August 15

In addition to the suspension of dollar convertibility and a program designed to reduce unemployment and domestic price-wage pressures, the President's program of August 15 imposed an additional tax (surcharge) of 10 percent on goods imported into the United States. The apparent purpose of the surtax was to set the stage for useful international negotiations to achieve a realignment of currencies and a better access to foreign markets for American producers. As a related measure, the President ordered a 10 percent reduction in foreign aid.

Table II
Selected Countries Affected by the
U.S. 10 Percent Supplemental Duty on Imports

Industrial Countries	Percent of Total Exports Affected	Exports Affected as Percent of Domestic GNP
Japan	29%	3%
Canada	16	4
Germany	9	2
Italy	9	1
United Kingdom	8	1
Belgium-Luxembourg	5	2
France	4	1
Netherlands	3	1

NOTE: Exports based on 1970 annual data compiled by U.S. Department of State; GNP based on annual data for latest year available, primarily from various OECD sources.

The President's *Economic Report* describes the import surcharge as applying only to "goods on which duties had been reduced under reciprocal trade agreements, and in no case . . . was it to raise a duty beyond the statutory rate. Where it was limited by the statutory ceiling, the surcharge was less than 10 percent. On automobiles, in particular, the tax amounted only to 6.5 percent. Furthermore, all imports subject to mandatory quantitative restrictions were exempt from the new tax. Such goods included petroleum, sugar,

²Federal Reserve swap lines with foreign central banks and the Bank for International Settlements were drawn on in the amount of \$3,565 million between January 1 and August 13. During the same period \$1,330 million in current and previous drawings were repaid by use of foreign currency balances and Special Drawing Rights, through U.S. borrowing from the International Monetary Fund, and through the sale of special securities to foreign official institutions. On August 15 there was a total of \$3,045 million of swap indebtedness outstanding compared to \$810 million on January 1.

meat and dairy products, certain other agricultural products, and cotton textiles covered by the Long-Term Textile Agreement. The surcharge affected about one-half of U.S. imports.³ Subsequent announcements confined the Job Development Tax Credit to domestically produced machinery and equipment as long as the import surcharge remained in effect.

Despite the price freeze on domestically produced items, prices of imported goods were allowed to rise by the full amount of the additional duty imposed. Prices of items assembled or produced in the United States with foreign components would also be allowed to rise by the amount of the additional duty levied on the foreign components. The President also removed the 7 percent excise tax on autos which was applicable to imported as well as domestic cars.

After August 15

The European exchange markets were closed for a week following the President's announcement. When the markets reopened, no major industrial country except France tried to maintain the value of its currency against the dollar within the one percent upper limit of its parity rate. In France, the foreign exchange market was separated into a market for dollars received as a result of international trade, in which the French continued to intervene to maintain the parity value, and a "financial franc" market in which all other exchanges were transacted. Although severe restrictions were imposed on inflows of funds through the financial franc market, the exchange rate was allowed to find its own level.

The Japanese government initially tried to purchase all dollars offered at the ceiling rate, but in face of a \$4.4 billion inflow in August, it was later forced to suspend the rate and limit intervention so as to permit about a 5 percent rise relative to the dollar in the subsequent month. Other administrative actions to assist in limiting the appreciation of the yen relative to the dollar over the remainder of the year included placement of a ceiling on all nonresident free yen deposits that Japanese commercial banks might receive, prohibition of prepayment of trade bills to Japanese exporters, and a request that banks not increase their Eurodollar borrowing. Many of these exchange controls were relaxed early in 1972.

Many other countries also imposed restrictions on foreign exchange transactions, but still permitted the

value of their currencies to fluctuate relative to the dollar. From time to time central banks intervened in markets to limit the pace at which their currencies appreciated relative to the dollar. By early December, it was clear that a set of regulated exchange rates between foreign currencies and dollars had emerged which was substantially different than at the beginning of the year. Many of the new exchange rates were formalized shortly after the Smithsonian agreement of December 18 by the declaration of temporary "central values," and the announcement by the United States of its willingness to raise the dollar price of gold by 8.57 percent and remove the import surcharge. Simultaneously, most countries agreed to permit exchange-rate fluctuations within a 2.25 percent range on each side of the central value.⁴

³Numerous alternatives were available to the United States in seeking a realignment of exchange rates after August 15. The desire to realign exchange rate patterns could have been achieved by: (1) permitting exchange rates to float upward to their new and higher levels vis-à-vis the dollar; (2) devaluation of the dollar against other currencies; (3) revaluation of other currencies against the dollar while leaving the value of the gold content of the dollar unchanged; and (4) a combination of devaluation of the dollar with respect to gold and a change in the exchange rates of other nations vis-à-vis the dollar and each other. In the end, the latter path was chosen.

One of the considerations in determining the extent of exchange-rate realignment was the state of the U.S. balance of payments. The Administration concluded that the size of the required correction would be an exchange rate realignment necessary to bring a turnaround of \$13 billion. Their calculations were as follows:

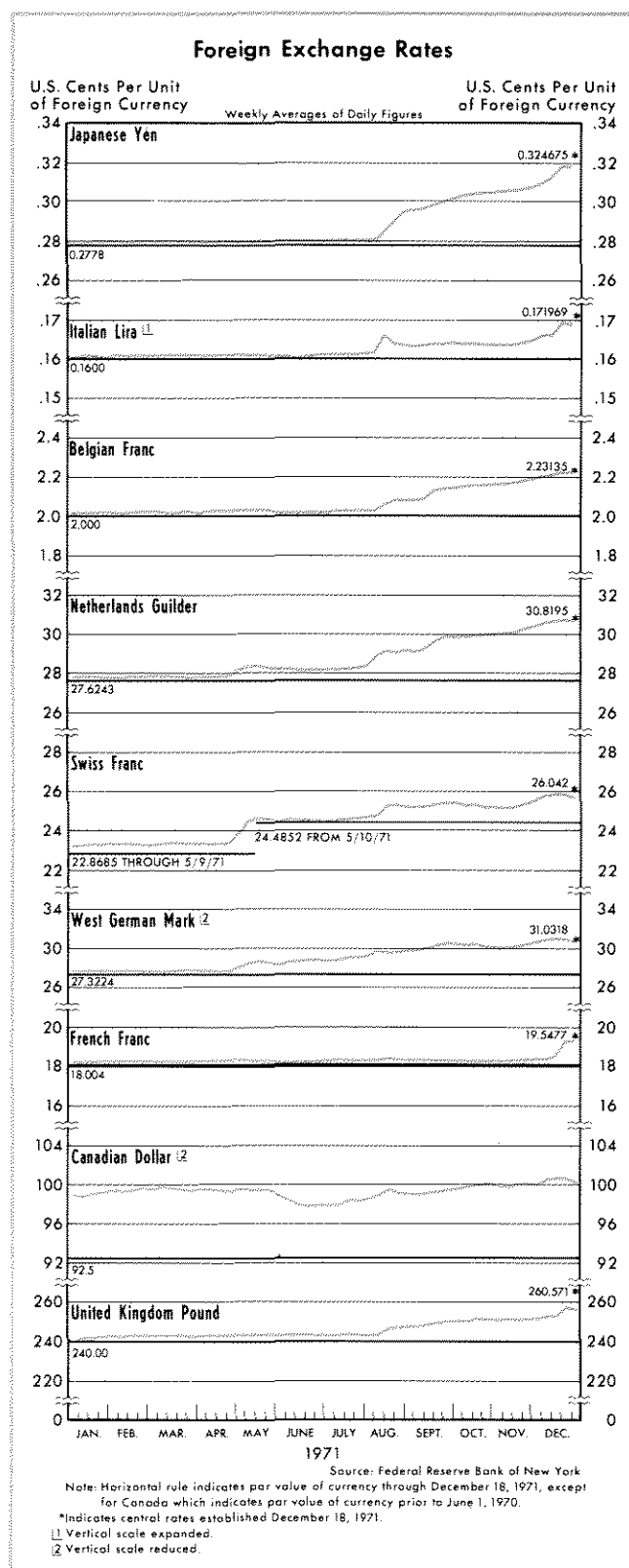
1. Under conditions of reasonably full employment in both the United States and other major trading countries, the U.S. deficit on current account (excluding U.S. Government grants) for 1972 was projected to be \$4 billion on the basis of the exchange rates and other trading conditions in effect in April 1971.

2. The annual outflow for Government grants and credits plus private long-term capital flows from the United States to countries other than Western European nations, Canada, and Japan was estimated at \$6 billion, or just over one-half of one percent of the U.S. gross national product. The average annual outflow for these purposes during the 5-year period from 1967 through 1971 was about \$5½ billion.

3. A secure payments position would require that this estimated \$6-billion capital outflow be covered by a surplus on current account. Since the projected "full-employment" current account for 1972 was in deficit by \$4 billion, achieving a surplus of \$6 billion required an improvement of \$10 billion in the U.S. current account.

4. Two other factors caused additions to this basic estimate. The first was an allowance of \$1 billion a year to cover a persistent outflow, which the data collection network does not capture. This outflow, which is shown as "errors and omissions" or unidentified transactions in the accounts, fluctuates from year to year, but it has been consistently negative since 1960, the average level being around \$1 billion. The second factor was an allowance of \$2 billion to provide the prospect of a small surplus on basic balance, to cover persistent short-term capital outflows or to serve as a margin of safety against errors in the underlying assumptions and calculations. With the addition of these two factors, the turnaround required for the United States to achieve a secure position was estimated to be \$13 billion. [*Economic Report of the President, 1972*, pp. 154-155.]

³*Economic Report of the President, 1972*, p. 148.



The effective devaluation of the dollar based on the new central rates for the 14 countries indicated in Table III was 10.35 percent on a trade-weighted

average basis. About two thirds of the total trade of the United States is conducted with these countries. Against all currencies that revalued relative to the dollar, the effective devaluation was about 9.7 percent on a trade-weighted basis. These countries account for about 80 percent of total U.S. trade. Finally, against all currencies of the world, including those which did not change their exchange rate with the dollar as well as those who did — such as Israel, Ghana, South Africa, and Yugoslavia — the effective dollar devaluation on a trade-weighted basis was about 7.5 percent. By December 31, currencies of the 14 countries in the table had appreciated only 9.05 percent relative to the dollar on a trade-weighted basis.

Balance of Payments Analysis

On a yearly basis, the United States balance of payments was in deficit by \$22 billion on a liquidity basis and \$29.8 billion on an official settlements basis in 1971, compared to deficits of \$3.8 billion and \$9.8 billion, respectively, in 1970. The liquidity deficit averaged \$3.4 billion from 1965 to 1969 and \$2.8 billion from 1960 to 1964. The official settlements balance averaged about zero from 1965 to 1969 and a negative

Table III Exchange-Rate Changes

	Percentage Changes Against the U.S. Dollar from pre- May 1971 Parities*, Expressed in U.S. Cents		Trade-Weighted Average Changes Against a Group of Major Currencies	
	New Central Rates	Market Rates Dec. 31	New Central Rates	Market Rates Dec. 31
United States dollar	0.00	0.00	-10.35	-9.05
Canadian dollar	+ 8.49**	+ 7.87	+ 5.58**	+ 5.44
Japanese yen	+16.87	+14.37	+11.93	+10.34
British pound	+ 8.57	+ 6.35	+ 0.67	- 0.43
German mark	+13.58	+12.01	+ 4.54	+ 4.24
French franc	+ 8.57	+ 6.45	- 1.31	- 2.20
Italian lira	+ 7.48	+ 5.28	- 1.90	- 2.76
Belgian franc	+11.57	+11.61	+ 1.51	+ 2.79
Dutch guilder	+11.57	+11.33	+ 1.17	+ 2.12
Swiss franc	+13.87	+11.75	+ 3.89	+ 3.39
Austrian schilling	+11.59	+ 9.59	+ 0.60	+ 0.22
Danish krone	+ 7.45	+ 6.26	- 1.31	- 1.17
Norwegian krone	+ 7.49	+ 6.56	- 1.41	- 1.04
Swedish krona	+ 7.49	+ 6.47	- 1.46	- 1.16
Australian dollar	+ 8.57	+ 6.12	- 0.24	- 1.15

*pre-June 1970 for Canada

**A central rate has not been set for the Canadian dollar. The December 17, 1971 market rate is used in lieu of a central rate.

Source: *World Financial Markets*, Morgan Guaranty Trust Company, January 19, 1972, p. 3. For method of computation see the article accompanying their table, and the October 18, 1971 issue of the same publication.

Table IV

U.S. Balance of Payments, 1960-71

(Billions of dollars)

Type of transaction	1960-64 average	1965-69 average	1968	1969	1970	1971
Merchandise trade balance	\$ 5.4	\$ 2.8	\$ 0.6	\$ 0.7	\$ 2.1	\$ -2.9
Exports	21.7	31.3	33.6	36.5	42.0	42.8
Imports	-16.2	-28.5	-33.0	-35.8	-39.9	-45.6
Military transactions, net	-2.4	-2.9	-3.1	-3.3	-3.4	-2.9
Balance on investment income ¹	3.9	5.8	6.2	6.0	6.2	8.0
U.S. investment abroad	5.1	8.6	9.2	10.5	11.4	12.7
Foreign investment in the United States	-1.2	-2.8	-3.0	-4.6	-5.2	-4.8
Balance on other services	-1.0	-1.2	-1.2	-1.3	-1.4	-1.5
BALANCE ON GOODS AND SERVICES²	5.9	4.4	2.5	2.0	3.6	0.7
Private remittances and government pensions	-7	-1.1	-1.2	-1.3	-1.4	-1.5
BALANCE ON GOODS, SERVICES, AND REMITTANCES	5.2	3.3	1.3	.7	2.2	-0.8
Government Grants ³	-1.8	-1.8	-1.7	-1.6	-1.7	-2.0
BALANCE ON CURRENT ACCOUNT	3.3	1.5	-4	-9	.4	-2.8
Balance on direct private investments	-1.8	-3.0	-2.9	-2.4	-3.5	-4.7
U.S. direct investment abroad	-1.8	-3.3	-3.2	-3.3	-4.4	-4.5
Foreign direct investment in the United States	.1	.3	.3	.8	1.0	-0.2
Balance on other long-term capital flows ⁴	-2.2	-.6	1.9	.4	(⁵)	-1.8
BALANCE ON CURRENT ACCOUNT AND LONG-TERM CAPITAL	-7	-2.2	-1.3	-2.9	-3.0	-9.3
Balance on nonliquid short-term private capital flows	-1.1	-.2	.2	-.6	-.5	-2.5
Errors and unrecorded transactions	-1.0	-1.0	-.5	-2.6	-1.1	-10.9
Allocations of special drawing rights	—	—	—	—	.9	.7
NET LIQUID BALANCE	-2.8	-3.4	-1.6	-6.1	-3.8	-22.0
Transactions in U.S. liquid short-term assets, net	-.1	.1	-.6	.1	.2	-1.1
Transactions in U.S. liquid liabilities to other than foreign official agencies, net	.8	3.3	3.8	8.7	-6.2	-6.7
OFFICIAL RESERVE TRANSACTIONS BALANCE	-2.2	(⁵)	1.6	2.7	-9.8	-29.8
Financed by change in:						
Nonliquid U.S. Government and U.S. bank liabilities to foreign official agencies ⁶	.1	.7	2.3	-1.0	-.3	-.2
Liquid liabilities to foreign official agencies	1.1	-.6	-3.1	-.5	7.6	27.6
U.S. official reserve assets, net	1.0	(⁵)	-.9	-1.2	2.5	2.3

¹Includes direct investment fees and royalties.²Excludes transfers under military grants.³Excludes military grants of goods and services.⁴Excludes official reserve transactions and includes transactions in some short-term U.S. Government assets.⁵Less than \$0.05 billion.⁶Excludes U.S. Government nonliquid liabilities to foreign official agencies other than official reserve agencies.

Note—Details will not necessarily add to totals because of rounding.

Source: Department of Commerce.

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Current Account

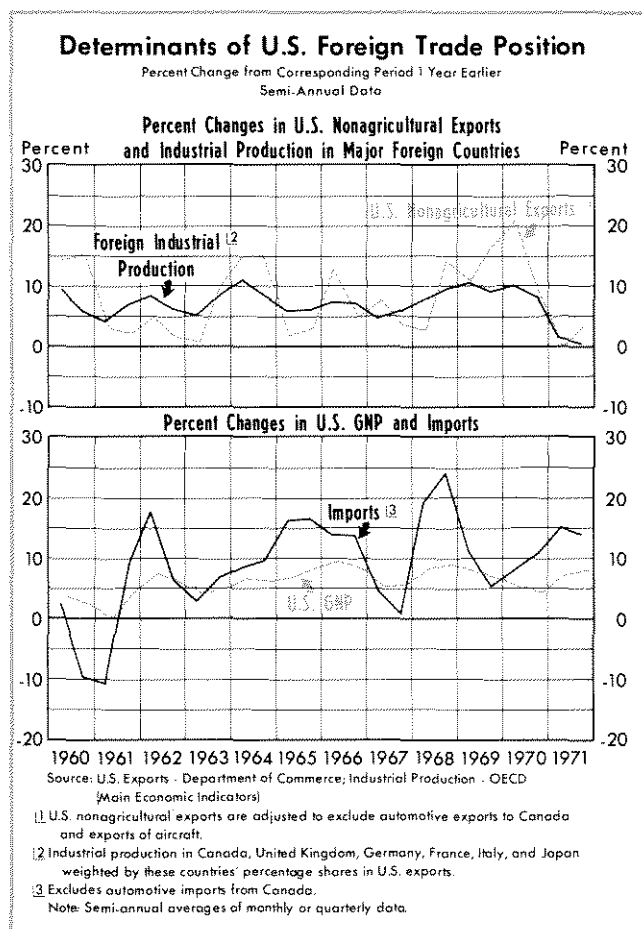
The trade account, which is an important component of the current account, declined from a surplus of \$6.8 billion in 1964 to a deficit of \$2.9 billion in 1971. Strikes had a particularly adverse effect on the balance in 1971, but deterioration can more generally be attributed to (1) the gradually increasing overvaluation of the dollar relative to other currencies, and (2) the relative income, output, and price trends in Europe and the United States. The effect of income, output, and price movements on the trade balance is discussed below.

As a general rule, movements of U.S. nonagricultural exports are related to income and output movements in other industrial nations. The accompanying chart shows that the rate of expansion in foreign industrial production varied between five and ten percent over the decade, and that fluctuations in the rate of expansion resulted in nearly simultaneous and wider fluctuations in U.S. export growth. The increase in the rate of expansion in foreign industrial production in 1967 and 1968 was followed by an acceleration in U.S. export growth, and a subsequent decline in the rate of foreign industrial production in 1970-71 by a deceleration in U.S. export growth.

Movements in U.S. imports are related to movements in U.S. GNP. Variations in GNP growth

\$2.2 billion from 1960 to 1964. Much of the deterioration of the balances in 1971 over 1970 reflected uncertainties associated with interest-rate differentials, and anticipated changes in the par value of the dollar and other exchange rates. However, there were sub-

stantial adverse movements on trade and long-term capital accounts as well. The trade account, which is an important component of the current account, declined from a surplus of \$6.8 billion in 1964 to a deficit of \$2.9 billion in 1971. Strikes had a particularly adverse effect on the balance in 1971, but deterioration can more generally be attributed to (1) the gradually increasing overvaluation of the dollar relative to other currencies, and (2) the relative income, output, and price trends in Europe and the United States. The effect of income, output, and price movements on the trade balance is discussed below.



Price as well as income movements determine the pattern of trade flows. Until late 1969 prices of goods exported from the United States rose substantially faster than those exported by the United States' competitors. However in 1970 and 1971, export prices of competitors rose 8.4 percent compared to 2.4 percent for U.S. goods, thereby improving the U.S. relative export position. Much of the relative improvement was apparently due to rapid domestic inflation in Europe (indicated by a rapid rise in costs per unit of production) which spilled over into the export sectors in 1970 and 1971.⁵

⁵Although both price and income movements proved more favorable to the United States in 1970 and 1971 than in previous years, much of the improvement can be attributed solely to the different cyclical positions of the United States and most European nations, and represents no fundamental improvement in the U.S. trade position. Both the OECD and the Federal Reserve Board have begun work to develop data on "cyclically adjusted" trade balances. The OECD's preliminary cyclical adjustment estimates indicate that the observed U.S. surplus of \$2.2 billion on current transactions (excluding Governments grants) in 1970 was \$2.4 billion higher than it would have been under "normal" conditions (defined as a condition of normal high employment in all OECD countries). U.S. calculations indicate a 1970 adjustment for cyclical and other special factors of \$2.8 billion, or an adjusted deficit of \$0.6 billion. A similar adjustment for

Table V

U.S. Relative Cost and Price Position, 1961-1971

Unit Value of Exports of Manufactured Goods:	United States	Competitors*
	1963=100**	
1961	100.2	101.1
1962	100.2	99.8
1963	100.0	100.0
1964	100.7	101.5
1965	104.0	102.5
1966	106.9	104.3
1967	110.2	105.6
1968	112.7	105.5
1969	117.6	109.3
I/1970	123.0	114.3
II/1970	124.0	116.5
III/1970	124.0	117.8
IV/1970	124.0	117.2
I/1971	128.0	118.0
II/1971	127.0	121.0
III/1971	126.0	124.0

Unit Labor Cost in Manufacturing:		
1961	102.0	98.5
1962	101.6	98.7
1963	100.0	100.0
1964	98.6	99.6
1965	99.1	103.3
1966	100.8	105.5
1967	103.7	105.4
1968	107.7	103.9
1969	111.6	106.0
I/1970	114.1	110.3
II/1970	114.4	113.7
III/1970	116.2	117.3
IV/1970	116.2	121.1
I/1971	118.0	121.0
II/1971	119.0	123.0
III/1971	120.0	129.0

*Weighted average for Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, and United Kingdom.

**Adjusted for changes in exchange rates.

Source: Department of Labor, International Monetary Fund, Council of Economic Advisers.

Private and Government Capital Accounts

A major component of the outflow of private capital in the 1960s has been private U.S. direct capital investment abroad. In the early 1960s the outflow averaged \$1.8 billion, compared to \$3.3 billion from 1965 to 1969. It reached \$4.4 and \$4.5 billion in 1970 and 1971, respectively. This outflow has been more than offset in most years by income on U.S. investments abroad (included in the current account) and by foreign direct investments in the United States. The flow of foreign direct investment to the United States increased markedly in 1969 and 1970 when cyclical conditions were favorable, but diminished to a deficit of \$0.2 billion in 1971.

the first three quarters of 1971 indicates the underlying trade balance was much less favorable than the observed figure of \$0.1 billion. *Economic Report of the President*, 1972, p. 153.

Private financial short-term capital flows generally respond to the stocks of assets held by U.S. and foreign residents as well as changes in those stocks, and the level of and changes in interest-rate differentials. In periods of greater than normal uncertainty, such as existed in part of 1971, speculative transactions may obscure these fundamental economic relationships. The major change in financial capital flows in 1971 was an increase in certain nonliquid short-term private capital outflows (loans by banks and nonbanks to finance foreign trade) by \$2.0 billion to \$2.5 billion from an average outflow of \$0.5 billion in 1970. Errors and omissions increased to a \$10.9 billion deficit in 1971 from a \$1.1 billion deficit in 1970. A small portion of these errors and omissions (about \$1 billion) represents errors in data collection and reporting. The remainder of the errors and omissions is probably highly interest-rate sensitive and reflects speculative short-term capital flows not captured by normal reporting procedures.

The net liquidity balance deteriorated in 1971 because of adverse movements on trade account, long-term private capital, and errors and omissions. The deficit was \$22 billion in 1971, compared to deficits of \$3.8 billion in 1970 and \$6.1 billion in 1969.

The change in accounting procedures made in mid-1971, which included liquid short-term assets along with liquid liabilities to other than foreign official agencies as a financing item of the net liquidity bal-

ance, decreased the net liquidity deficit by \$1.1 billion in 1971, while increasing it \$0.2 billion in 1970. The accounting change which included nonliquid U.S. Government and long-term U.S. bank liabilities to foreign official agencies as financing items of the liquidity balance decreased the liquidity deficit by a billion dollars or less in each of the last three years.

Official Settlements Balance

The official settlements balance increased to a \$29.8 billion deficit in 1971 from a \$9.8 billion deficit in 1970 and a \$2.7 billion surplus in 1969. The shift from surplus to deficit in the past two years reflected net outflows of liquid private capital in addition to the adverse movements on trade account, long-term private capital, and errors and omissions which contributed to the liquidity deficit. These liquid dollar movements shifted from inflows of \$3.2 billion and \$8.8 billion in 1968 and 1969, respectively, to outflows of \$6.0 billion and \$7.8 billion in 1970 and 1971, respectively. Much of the outflow was associated with repayment of Euro-dollar liabilities of U.S. banks to their foreign branches and agencies.

The official settlements balance was financed in 1971 by a reduction in reserve assets of \$2.3 billion and a net increase of liquid and certain nonliquid liabilities to foreign official agencies of \$27.4 billion. Most of the reduction in reserve assets occurred before August 15.

